

First Supplement to Memorandum 2000-63

Mechanic's Liens (Commentary from Consultants)

We have received additional commentary from the Commission's consultants on mechanic's liens.

Report from Gordon Hunt

Gordon Hunt will not be able to attend the October meeting because he is speaking at a conference on California construction law, but he has submitted a report giving his analysis of "Current Proposals Pending Before the Commission Regarding Changes to the Mechanic's Lien Law." The Report is set out in the Exhibit to this supplement.

Mr. Hunt provides a brief summary and analysis of the direct pay proposal, the full-payment defense, mandatory bonding on home improvement contracts, and the homeowner's relief recovery fund proposal. After discussing each of these approaches, he recommends that the law "not be changed to address the alleged 'double payment' problem." However, if revision is desired, he suggests focusing on the 50% home improvement bond presented in the memorandum. As a secondary approach, he suggests further consideration of Prof. Kelso's "Homeowner Relief Recovery Fund." (See Report, p. 5-6.)

New Suggestion from James Acret

James Acret has submitted an alternative suggestion for dealing with the single-family, owner-occupied dwelling double-payment issue. He recommends adding the following sentence to the mechanic's lien statute:

No claimant shall have mechanic's lien or stop notice rights against a single-family home occupied or to be occupied by its owner unless the claimant has a direct contractual relationship with the owner.

Like the full-payment defense, this approach is simple and easy to grasp. Unlike the defense proposal, it does not depend on a determination of good faith payment to the prime contractor, and it operates without the need to raise a defense in litigation. Presumably, subcontractors and suppliers would know up

front that they would need to make other arrangements or rely on the prime contractor in any case involving a single-family, owner-occupied dwelling.

This suggestion would sweep away all of the preliminary notice paperwork, where there is no privity, and put the parties in the same business relationship experienced generally. It might also permit or encourage the sort of “direct payment” regime by standard market mechanisms that we had tried to direct by statute in the direct payment draft considered at the last meeting. The owner would pay the prime contractor and would pay other parties with whom he or she had a contractual relationship, in accord with common sense. Bills would be paid as they become due and are presented for payment. Lien rights would arise only when the owner did not pay bills as they became due. Payments to the prime contractor, in the absence of a relationship with a subcontractor or supplier, would discharge the owner’s obligation to all parties.

Ellen Gallagher suggests that the reaction would (or should) be that subcontractors and suppliers would create a clearinghouse of reliable contractors — those who pay on time, not necessarily ones with great credit ratings. Where there are doubts, subcontractors and suppliers could resort to joint control accounts or could require bonds.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

**Report to
Law Revision Commission Regarding
Current Proposals Pending Before the
Commission Regarding Changes to the
the Mechanic's Lien Law**

Gordon Hunt

August 2000

This report was prepared for the California Law Revision Commission by Gordon Hunt of Hunt, Ortmann, Blasco, Palffy & Rossell, Inc., Pasadena. No part of this report may be published without prior written consent of the Commission

The Law Revision Commission assumes no responsibility for any statement made in this report, and no statement in this report is to be attributed to the Commission. The Commission's action will be reflected in its own recommendation, which will be separate and distinct from this report. The Commission should not be considered as having made a recommendation on a particular subject until the final recommendation of the Commission on that subject has been submitted to the Legislature.

Copies of this report are provided to interested persons solely for the purpose of giving the Law Revision Commission the benefit of their views, and it should not be used for any other purpose at this time.

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Current Proposals Pending Before the Commission Regarding Changes to the the Mechanic's Lien Law

Gordon Hunt

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1. Introduction

This report is to comment upon proposals now pending before the Law Revision Commission and which proposals were discussed at the Law Revision Commission meeting of July 20, 2000. Your consultant will be unable to attend the meeting in October by reason of a conflict in schedule. Your consultant respectfully requests that the following comments be considered at said meeting.

2. Direct Pay Proposal

The Contractors State License Board (CSLB) has submitted a proposal for "Direct Pay". That proposal was commented upon in the staff memorandum dated July 14, 2000, being Memorandum 2000-47. Essentially, the direct pay proposal submitted by Ellen Gallagher of the CSLB would permit subcontractors and suppliers to request direct payment from the owner. The prime contractor, in turn, would authorize payment, but the homeowner would pay the claimant giving the direct pay notice instead of the prime contractor. This proposal has some merit in that it allows the owner to pay the subcontractors and suppliers direct thereby preventing the prime contractor from diverting the owner's funds. It also gives the subcontractor and suppliers the option to decide whether or not they want to retain their lien rights or rely on their customer for payment. The primary deficit in this proposal is that it puts the homeowner "in the middle" with regard to any disputes either between the prime contractor and his or her subcontractors or any disputes between either the prime contractor or a subcontractor with regard to any direct payment requests made by material suppliers. On home improvement contracts, disputes sometime arise as to scheduling, adequacy of workmanship, offsets and credits, change orders and other items

that arise during the progress of the job. For example, the prime contractor may contend that a particular subcontractor is not properly manning the job or is performing defective workmanship and therefore, the prime contractor would not want the owner to pay such a subcontractor who had given a "direct pay notice". Likewise, disputes may arise between prime contractors and subcontractors with regard to whether or not certain work is a change in scope. Disputes sometime arise between material suppliers and subcontractors or material suppliers and prime contractors with regard to late delivery of material and/or defective material. Subcontractors and material suppliers, under the direct pay proposal, would submit the direct pay notice and request payment and the prime contractor would then instruct the owner not to pay them. The owner would then be caught in the middle of the dispute between the prime contractor and the subcontractors and suppliers.

As noted above, this proposal has merit for the reasons stated above. If the Commission decides to pursue this proposal further, this consultant will have specific comments on the currently-drafted proposed statutes.

3. Full Payment Defense

This proposal has its genesis in the legislation introduced by Assemblyman Honda. It provides, in effect, that where the owner of a single-family owner occupied dwelling has paid the full amount due for the work of improvement under the contract with the prime contractor, including change orders, the owner is not liable to any lien claimant if the contract with the prime contractor represents a good faith valuation of the work to be performed and the equipment and materials to be supplied and at the time of payment, the owner does not have knowledge of any dispute between the prime contractor and any other claimants arising out of the work of improvement. The essential feature of this proposal is that an owner who has paid the contractor in full would not be subject to Mechanic's Liens on his or her property. As noted by this consultant many times before in prior submissions, this consultant strongly urges the Commission not to adopt this proposal. The reasons for this consultant's recommendation have been previously stated. Essentially, it represents a substantial departure from the current legislative scheme enforcing the constitutionally guaranteed right of Mechanic's Lien. This consultant believes such a statute would be unconstitutional; that there is already adequate protection in the Mechanic's Lien law for homeowners under the payment bond provisions of the Mechanic's Lien law; such a proposal would cause the cost of home improvements to go up substantially and fewer contractors and subcontractors would be able to do business in the home improvement field by reason of the substantial restriction in credit that would result.

As noted in prior submissions of this consultant, in those rare occasions where an owner ends up paying twice, the party who caused the loss should bear the loss, to-wit, the prime contractor. The owner can require the prime contractor to provide payment bonds under the current Mechanic's Lien law and thereby insulate its real estate from Mechanic's Liens and insulate its construction loan from bonded Stop Notices (except a bonded Stop Notice filed by the prime contractor). In that rare instance where the owner ends up paying twice, the owner can

seek recovery back from the prime contractor and against the surety on the prime contractor's license bond.

As a result of the foregoing, this consultant recommends that the full payment defense not be enacted.

4. Mandatory Bonding on Home Improvement Contracts

All parties have acknowledged that the alleged "double payment" problem is not a significant one. It is significant to the particular homeowner who ends up paying twice and therefore, the Commission, your consultant and others who have appeared at the various Commission hearings have struggled with a method to resolve what appears to be a limited problem in the overall scheme of the Mechanic's Lien law and the construction industry in California.

At the last meeting of the Commission, this consultant recommended a compromise that would be directed at those small home improvement contracts that may, on occasion, result in "double payment". At the hearing, this consultant recommended that on all home improvement contracts (as described in Proposed Section 3107.1, in Exhibit 1 to Memorandum 2000-47) of \$25,000.00 or less, the contractor would have to provide a payment bond of 50% of the contract price. This payment bond would be in accordance with the current provisions of the Mechanic's Lien law governing payment bonds for private works of improvement as set forth in Civil Code §§3235 to 3242, inclusive. The only private projects upon which payment bonds would be required would be home improvement contracts of \$25,000.00 or less. Thus, the small home improvement contract where homeowners are perceived to be the most vulnerable would be fully protected against Mechanic's Liens by virtue of said bond. The claimants would have to proceed against the payment bond surety. The bond would be 50% of the contract price as that is the current requirement in Civil Code §3235. As a result of the foregoing proposal, the maximum bond that would have to be obtained by home improvement contractors would be \$12,500.00 or less.

The current contractor's license bond is \$7,500.00 and all contractors and subcontractors doing business in California are able to obtain that bond. The homeowner would have that bond to look to for any other defaults by a prime contractor. Under the compromise proposal, the claimants would not be entitled to either Mechanic's Liens or bonded Stop Notices where the owner had paid the contractor in full, and would be limited to seeking recovery on the payment bond. It is the belief of this consultant that such a limited bond would be available to home improvement contractors from the surety companies that currently write the contractors license bonds. This would provide an additional market to those surety companies. They may have to do some additional underwriting in order to write these bonds. That underwriting would inure to the benefit of the homeowners as well.

This proposal has many benefits. First of all, it addresses the alleged "double payment"

problem on the projects where the homeowners may be vulnerable (i.e. the small project): The \$25,000.00 cutoff is arbitrary and could be \$30,000.00, \$40,000.00 or \$50,000.00; it provides mandatory protection for the innocent homeowner; it provides a source of recovery for the subcontractor and suppliers that have not been paid; it places the loss on the party causing the loss, to-wit, the defaulting contractor and the small amount of the bond will make it a bond that home improvement contractors will be able to obtain.

There are other details that would have to be developed under this proposal. For example, homeowners and contractors would have to be made aware of the requirement. This could be covered in the Notice to Owner required under the license law (B&P §7018.5). There would be penalties to the contractor for non-compliance such as disciplinary action and inability to seek recovery from the owner on the contract similar to the bar of B&P §7031 (non-licensed contractors cannot recover on their contracts). This consultant stands ready, willing and able to work with staff to work out the details of the statute.

It is respectfully submitted by this consultant that this approach is a more viable approach to the alleged double payment problem than the full payment defense.

5. Homeowner's Relief Recovery Fund Proposal

Professor Clark Kelso, writing for the Institute for Legislative Practice, proposes an insurance scheme to address this alleged problem of double payment. The proposal is set forth in Professor Kelso's letter of July 18, 2000, attached to the Staff Memorandum dated July 18, 2000, entitled "First Supplement to Memorandum 2000-47". Said proposal is funded by virtue of a fee added to the building permit based upon the value of the project. The appropriate amount of the fee would have to be studied and adjusted as time went on.

Professor Kelso designates this as a "insurance type program". Professor Kelso correctly points out that if there were a contractor default recovery fund funded by fees charged to contractors, that cost would still be passed on to the homeowners in their markups for overhead and profit on their projects. It therefore makes sense that since the homeowners are ultimately going to be charged with the increased costs of creating such a fund that it be tied to the building permit. The fund which Professor Kelso calls the "Homeowner's Relief Recovery Fund" (HRRF) would be administered by the Contractors State License Board which would be used to make payments to subcontractors or homeowners in situations where the homeowner has already paid the general contractor for work performed by the subcontractor or material supplier. The "homeowners lien protection fee" added to the residential building permit fees would be collected by the local building department at the time a residential building permit is issued and after a deduction for local expenses associated with the collection of the fee would be forwarded to the State Treasury for deposit in the HRRF. Professor Kelso notes that he is not breaking any new ground in proposing that a State Fund be financed by fees on building permits, referring to the "Strong Motion Instrumentation Program" (Public Resources Code §2700-2709.1) which requires that all persons receiving building permits pay an additional fee, the amount of which is in relation

to the total value of all labor and materials to be used in the building project. As a result, notes Professor Kelso, there is already a mechanism for using county and city building permit fees to support a statewide program. As noted by Professor Kelso under that approach, the cost of protecting homeowners against the risk of double payment will be born by the homeowners themselves, which is appropriate since they are the ones who most directly benefit from the change in law proposed by the legislation.

Professor Kelso makes no attempt to suggest how large the fee should be to provide sufficient funds for the HRRF to operate properly. If such legislation were adopted, a fee would have to be established and then monitored on a yearly basis to determine whether or not it is adequate. The proposed legislation which Professor Kelso attaches is based largely upon Assemblyman Honda's legislation.

One of the primary objectionable portions of Professor Kelso's proposed legislation is that which limits the amount of any claim that can be made on a single-family owner occupied residence to \$75,000.00 and \$250,000.00 per claimant over the claimant's lifetime. The amount of recovery should not be limited at all. Since the fund is substituting for the Mechanic's Lien, there should be no limitations on the amount that would be recoverable. These projects are, after all, small home improvement contracts and the claims will be limited. There are subcontractors and material suppliers who deal exclusively in home improvement contracts and there should be no limit on the amount that they could recover. Any limitation on the amount recoverable, this consultant believes, would be unconstitutional.

If the Commission perceives that the mandatory bonding proposal set forth above is not the appropriate solution to the so-called double payment problem, then this consultant urges the Commission to adopt Professor Clark Kelso's "Homeowner's Relief Recovery Fund" proposal. If the Commission elects to pursue this proposal, this consultant would want the opportunity to comment further on the statutory details. This consultant stands ready, willing and able to work with staff concerning the details of the proposed legislation.

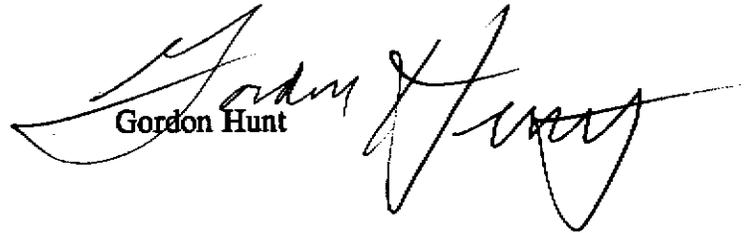
6. Conclusion

This consultant recommends that the Mechanic's Lien law not be changed to address the alleged "double payment" problem. If a change is to be made, this consultant recommends that the mandatory bonding proposal set forth above (a 50% payment bond on home improvement contracts of \$25,000.00 or less) is the appropriate solution to the alleged problem. If the Commission feels that the mandatory bonding proposal is not the appropriate approach, then this

consultant recommends that the Commission adopt Professor Clark Kelso's "Homeowner's Relief Recovery Fund" proposal.

August 17, 2000

Respectfully submitted,


Gordon Hunt